

## CALIFORNIA FRANCHISE TAX BOARD

Legal Ruling No 263

September 17, 1964

### DEDUCTION: LEGAL EXPENSE

#### Syllabus:

Taxpayers contended that they became residents of California on July 1, 1951, but the Franchise Tax Board determined that they were residents of this State commencing on July 1, 1948. Proposed assessments of additional personal income tax were made against the taxpayers on income received during the period July 1, 1948 to July 1, 1951. Taxpayers protested and appealed the deficiencies. The matter was finally settled by decision of the State Board of Equalization holding that taxpayers were not residents of California during the period in dispute. Taxpayers paid legal fees in the years 1953, 1954, 1956 and 1958 for counsel to represent them in the proceedings. They claimed deductions for the legal expenses on their returns for the years in which the payments were made.

Are the legal fees deductible?

Legal fees paid in connection with the determination of liability for taxes on income are ordinarily deductible. 1954 Regulation 17302.5 Ch. 252; 1955 Personal Income Tax Law Section 17252(c). However, the regulation further provides that the amount otherwise deductible under the section is not allowable if disallowed under Section 17351(c) (now, Section 17285) because allocable to a class of tax-exempt income. It is the position of the Franchise Tax Board that legal fees related to income for taxable years prior to the date a taxpayer became a resident of this State are not allowable as a deduction when paid in years thereafter for the reason that such fees are allocable to income exempt from tax by this State.

Since the expense must be deducted in the year paid, the taxpayer is in the predicament of not knowing at that time whether or not the amount is deductible. Allowability will not be established until the question of residence is decided.

A similar predicament arises in the situation where a legal expense (which is otherwise within a category of allowable deductions) is paid in defense of a criminal action prior to the year in which guilt or innocence is ultimately established. If the defendant is ultimately found guilty the expense is not deductible, but if he is innocent the expense is deductible. This issue arose, and was decided adversely to the taxpayer, in the case of Joseph Cohen, 2 TCM 602, Dkt. No.110869, entered August 4, 1943. The court rejected the possibility of allowing the amount of the expense to be deducted in the year paid and subsequently expecting the taxpayer to file an amended return and pay the

tax if the future event determined that the amount was disallowable. Rather, it decided that "a much more practical rule and one easier of administration would be the disallowance of the deduction where its ultimate propriety is unknown." The court felt that the taxpayer could file an amended return and claim a refund in the event the expense turned out to be deductible.

It is concluded that the same rule should be applied in the instant situation.